

PEABODY COAL CO.

IBLA 95-174

Decided June 3, 1997

Appeal from a Decision of the Associate Director, Minerals Management Service, denying an appeal of an order to pay royalties on the value of a loading facility provided by the coal purchaser. MMS-90-0302-MIN.

Affirmed.

1. Coal Leases and Permits: Royalties--Mineral Leasing Act: Royalties

The pre-Mar. 1, 1989, regulations governing valuation of coal for royalty purposes prohibit the deduction of the costs of loading from gross value in determining value for Federal royalty purposes. Where the coal purchaser provides the loading facility, MMS properly requires the lessee to add the value of the buyer's assumption of part of the costs of loading the coal to the sales price of the coal to determine value for Federal royalty purposes.

2. Coal Leases and Permits: Royalties--Mineral Leasing Act: Royalties

The coal valuation regulations effective Mar. 1, 1989, require the lessee to place coal in marketable condition at no cost to the Federal Government and provide that value for royalty purposes, when based on a lessee's gross proceeds, will be increased to the extent gross proceeds have been reduced because the purchaser provides services the cost of which is ordinarily the responsibility of the lessee to place the coal in marketable condition. Where the coal purchaser provides the loading facility and thus assumes part of the cost of fulfilling the lessee's duty to place coal in marketable condition, MMS properly increases the lessee's gross proceeds by the value of the costs adopted by the purchaser.

APPEARANCES: Michael H. Hyer, Esq., Flagstaff, Arizona, for Peabody Coal Company; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., Howard W. Chalker, Esq., Sarah L. Inderbitzin, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

## OPINION BY ADMINISTRATIVE JUDGE HUGHES

Peabody Coal Company (Peabody) has appealed from a June 16, 1994, Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS or the Service), denying its appeal of a May 14, 1990, MMS Order directing Peabody to include the cash value of a loadout facility provided by the coal's purchaser in Peabody's gross proceeds for royalty valuation purposes for the period November 1987 through September 1989. <sup>1/</sup>

Peabody mines coal from its Big Sky Mine in eastern Montana and sells the coal to Minnesota Power & Light Company (Minnesota Power) pursuant to a long-term coal supply agreement executed on July 29, 1968. The sales agreement is an arm's-length, fixed-price-plus-escalation contract with an initial established price subject to change based on contract price adjustment clauses. Section 14 of the agreement authorizes adjustments to the original base prices to reflect actual changes in the cost per ton to Peabody of producing, preparing, and delivering the coal f.o.b. railroad cars at the mine.

A rapid load facility at the Big Sky Mine was completed in 1973. In accordance with a January 17, 1973, agreement, Minnesota Power leases the loadout facility from the financial institution owning the facility and pays the property taxes and insurance premiums, as well as annual rental payments. Peabody operates and maintains the facility and pays all associated maintenance and operating costs.

Peabody obtained the lease at issue, Federal Coal Lease No. M-063202, effective December 1, 1986, as a bypass lease. That lease, which was subject to a 12.5 percent of value royalty rate, became part of the Big Sky Mine. Production from the lease began in November 1987 and ended in September 1989 when the reserves were mined out.

By letter dated August 7, 1989, the Royalty Valuation and Standards Division (RVSD), MMS, advised Peabody of its preliminary conclusion that, due to Minnesota Power's participation in the costs of the loadout facility, the coal sales price received by Peabody might not represent the full value of the coal for royalty purposes. It requested that Peabody provide additional details about the loadout facility and the selling arrangement between Peabody and Minnesota Power.

By letter dated September 5, 1989, Peabody submitted the information requested by RVSD.

On May 14, 1990, RVSD issued its final determination of value for royalty purposes. It concluded that Minnesota Power provided a noncash benefit to Peabody in addition to the invoiced price by assuming

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<sup>1/</sup> Although the Associate Director's Decision and the MMS Order identified Peabody Holding Company, Inc., as the party in interest, Peabody Coal Company, the operating subsidiary of Peabody Holding Company, Inc., filed both the appeal to the Associate Director and the appeal to the Board.

the capital cost of the mine loadout facility, and that, therefore, the proper basis for valuing the lease coal sold to Minnesota Power during the period November 1987 through September 1989 was the arm's-length contract gross proceeds, including the consideration attributable to the loadout facility. It also directed Peabody to furnish additional information to enable RVSD to calculate the incremental value associated with the loadout facility.

Peabody appealed the RVSD Order to the Director, MMS. Peabody denied that Minnesota Power provided a noncash benefit through the ownership and use of the loadout facility and accused MMS of attempting to unilaterally change terms of existing coal contracts. Peabody also objected to the retroactive application of the March 1, 1989, revised valuation regulations. Peabody asserted that, in any event, the MMS royalty valuation violated section 6 of the Federal Coal Leasing Act Amendments of 1976 (FCLAA), 30 U.S.C. § 207(a) (1994), the pre-March 1, 1989, coal valuation regulations, and the revised coal valuation regulations.

In her June 16, 1994, Decision, the Associate Director stated that both the past and the current coal valuation regulations reflected the longstanding MMS policy of requiring royalty on all elements of the value of produced coal, including noncash benefits conferred upon the seller by a coal sales agreement. She cited the lessee's well-established responsibility for all expenses associated with severing the coal from the ground and removing it from the mine and observed that, since the loadout facility was part of the mining operation, the costs attributable to its construction, operation, and maintenance were the obligation of the lessee.

She rejected Peabody's claim that the use of the facility did not constitute a noncash benefit, finding that Minnesota Power's provision of the loadout and payment of the annual rental, taxes, and insurance conferred a substantial monetary benefit by relieving Peabody of those costs. She discounted Peabody's assertion that the arrangement had no effect on the negotiated price of the coal since Peabody had offered no explanation as to why Minnesota Power would have expended these moneys without receiving a benefit in return. Accordingly, she concluded that Minnesota Power's loadout facility-related expenditures comprised additional consideration flowing to Peabody for the purchase of lease production.

The Associate Director denied that MMS was altering the sales agreement between Peabody and Minnesota Power. She also countered Peabody's retroactive application argument by noting that the pre-March 1, 1989, regulations also required the inclusion of loading costs assumed by a third party in the lessee's gross proceeds for royalty purposes. Since those regulations explicitly specified that loading costs were not deductible from gross value, she held that the shouldering of any portion of those costs by the coal purchaser constituted a noncash benefit includable in gross value for royalty valuation purposes. Accordingly, she denied Peabody's appeal.

In its Statement of Reasons for appeal, Peabody disputes the significance of Minnesota Power's payment of the loadout facility's lease costs to the computation of royalties on the lease. Peabody asserts that considering royalty value as the above-market contract sales price plus the ownership costs of the loadout facility produces an unwarranted windfall for the Government impermissible under FCLAA and its implementing regulations. According to Peabody, section 6 of FCLAA requires that royalty be based on the fair market value of the produced coal, and the coal valuation regulations must comport with that statutory principle. Peabody contends that the regulations as applied by MMS in this case violate the statutory mandate that royalty be grounded on the actual value of the coal.

Peabody considers fallacious MMS' conclusion that the price of the coal to Minnesota Power would increase by the amount of the loadout facility ownership costs if Peabody bore those costs, arguing that the value of coal is not simply the sum of its production costs. Peabody argues that, in a competitive market, the marketplace sets coal prices. Peabody avers that, if it assumed the loadout facility ownership costs, the coal price would only increase (if at all) to the extent permitted by prevailing market conditions. Given that the price Minnesota Power paid Peabody pursuant to the coal sales agreement exceeds the prevailing market price for comparable coal, Peabody asserts that any renegotiation of the coal supply agreement to provide for Peabody's ownership of the loadout facility would likely result in a substantial decrease in the coal price, not the increase postulated by MMS. Peabody submits that augmenting the already above-market value coal sales price on the ground that the increase depicts the true value of the coal creates a coal value unrelated to the actual value of the coal and violates FCLAA.

Peabody argues that the pre-March 1, 1989, valuation regulations, 30 C.F.R. § 203.200(f) and (g) (1986), direct MMS to use the sales price as the value of the coal for royalty purposes absent a determination that the sales contract is not a bona fide transaction between independent parties.

Because the coal supply agreement is a bona fide transaction between independent parties, Peabody insists that MMS must accept the sales price as the value for royalty purposes. Peabody adds that MMS cannot both reap the royalty windfall by accepting the sales contract as a bona fide transaction and then deny the contract's validity in order to further increase the coal's royalty value.

Peabody maintains that the current regulatory scheme, specifically 30 C.F.R. § 206.257(h), also does not authorize MMS to increase the sales price by the loadout facility ownership costs for royalty valuation purposes. Although this regulation allows MMS to increase coal value to the extent gross proceeds have been reduced because the purchaser provides services, the cost of which ordinarily falls within the lessee's duty to place the coal in marketable condition, Peabody submits that MMS has not shown that Minnesota Power's ownership of the loadout facility has in fact

decreased the gross proceeds. Peabody avers that, to the contrary, even if Peabody had owned the loadout facility, market conditions would have prevented Peabody from raising the price of the coal to recover ownership costs. Since Minnesota Power's ownership of the facility during the relevant period did not diminish the gross proceeds to any extent, Peabody contends that 30 C.F.R. § 206.257(h) is inapplicable, and that the MMS Decision must be reversed.

In its Answer, MMS argues that Peabody owes royalties on the value of the loadout facility since that facility was vital to placing the coal in marketable condition. The Service asserts that the pre-March 1, 1989, regulations identify loading as necessary to place coal in marketable condition and specify that loading costs may not be deducted from gross value in determining royalty value. Since the coal's price depended on the costs of producing and marketing the coal, MMS contends that Minnesota Power's providing the loadout facility reduced Peabody's costs and the dependent price Minnesota Power paid for the coal. The Service maintains that this arrangement effectively deducted the loading costs from gross value in violation of 30 C.F.R. § 203.200(f), (g), and (h) (1986). The Service submits that the revised regulations also require the lessee to bear all the costs of placing the coal in marketable condition including loading costs. The Service avers that Peabody's gross proceeds, which depended on its production costs, were reduced by Minnesota Power's furnishing of the loadout facility, and that MMS was, therefore, required to increase the gross proceeds by the costs of the loadout facility since those costs are part of the costs of mining.

The Service dismisses Peabody's contention that the valuation decision violates FCLAA. It contends that Peabody has misstated 30 U.S.C. § 207(a) (1994), which actually provides for royalty based on the coal's value "as defined by regulation," and that the valuation determination fully complies with both the statute and its implementing regulations. The Service denies that the pre-March 1, 1989, regulations mandate acceptance of the contract price as royalty value absent a determination that the contract is not a bona fide transaction between independent parties. The Service avers that, even without such a determination, 30 C.F.R. § 203.200(h) (1986) prohibits acceptance of the sales price if costs required to place the coal in marketable condition have been subtracted from that price. The assumption of marketing costs by a third party does not relieve the lessee of its marketing obligations, MMS adds, and Peabody cannot reduce its royalty payments by agreeing that its coal purchaser is responsible for providing the loadout facility.

The Service also disputes Peabody's contention that 30 C.F.R. § 206.257(h) does not justify increasing royalty value above the sales price because Minnesota Power's providing the loadout facility did not reduce Peabody's gross proceeds. The Service repeats that, under the 1968 coal supply agreement, the sales price hinges on Peabody's production costs and asserts that the agreement required Minnesota Power to pay Peabody for the costs of the loadout facility, without which the coal could not be loaded on the "railroad cars." The agreement obligated Minnesota Power to include the costs of loading the coal in the price it paid Peabody, MMS contends, and the regulations required Peabody to pay royalty based on that

contract price. Accordingly, Minnesota Power's assumption of the responsibility for providing the loadout facility in accordance with the 1973 rapid loadout facility contract improperly reduced Peabody's gross proceeds for royalty purposes. The Service concludes that, in accordance with 30 C.F.R. § 206.257(h), the costs of the loadout facility must be added to the sales price to determine Peabody's gross proceeds for royalty valuation purposes.

[1] Section 6(a) of FCLAA, 30 U.S.C. § 207(a) (1994), sets coal lease royalty at "not less than 12½ per centum of the value of coal as defined by regulation." When Peabody commenced production from Federal Coal Lease No. M-063202 in November 1987, the applicable coal valuation regulations stated:

(f) Where Federal royalty is calculated on a percentage basis, the value of coal for Federal royalty purposes shall be the gross value at the point of sale, normally the mine, except as provided at 30 CFR 203.200(h). \* \* \*

(g) The gross value shall be the unit sale or contract price times the number of units sold, unless MMS determines that:

(1) A contract of sale or other business arrangement between the operator/lessee and a purchaser of some or all of the coal produced from the Federal lease is not a bona fide transaction between independent parties because it is based in whole or in part upon considerations other than the value of the coal[.]

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(h) If additional preparation of the coal is performed prior to sale, such costs shall be deducted from the gross value in determining value for Federal royalty purposes. \* \* \*  
However, the following shall not be deducted from the gross value in determining value for Federal royalty purposes: costs of primary crushing, storing, and loading \* \* \*.

30 C.F.R. § 203.200 (1986), redesignated 30 C.F.R. § 203.250, 53 Fed. Reg. 1218 (Jan. 15, 1988).

Peabody argues that the regulations mandate MMS' acceptance of the sales price as the gross value of the coal produced and sold to Minnesota Power because the 1968 coal supply agreement was an arm's-length, bona fide arrangement between autonomous parties. We disagree. While 30 C.F.R. § 203.200(g) (1986) delineates those situations in which MMS will reject the contract price as indicative of gross value and provides the criteria for determining gross value in those circumstances, that regulation does not supplant the adjustments to and deductions from gross value set out in 30 C.F.R. § 203.200(h) (1986).

It is the obligation of the lessee to place the coal in marketable condition, and this duty generally entails placing the coal in a loadout facility where the buyer can readily take possession. Western Fuels-Utah, Inc., 130 IBLA 18, 31 (1994). Under the express terms of 30 C.F.R. § 203.200(h) (1986), the costs of loading are not deductible from gross value in determining value for royalty purposes. It is irrelevant who performs that activity. See Apache Corp., 127 IBLA 125, 134 (1993). By furnishing the coal loadout facility, Minnesota Power relieved Peabody of part of the expense of loading the coal. Those loading costs, however, are Peabody's responsibility, and the portion of those costs assumed by Minnesota Power may not be deducted from gross value. We find that MMS properly directed Peabody to add the value of these assumed costs to the sales price of the coal to determine the royalty value of the coal sold to Minnesota Power prior to March 1, 1989.

[2] The revised coal royalty valuation regulations, effective March 1, 1989, establish the value of coal sold pursuant to an arm's-length contract as "the gross proceeds accruing to the lessee," subject to various exceptions. 30 C.F.R. § 206.257(b)(1). The regulations define gross proceeds for royalty purposes as follows:

Gross proceeds (for royalty purposes) means the total monies and other consideration accruing to a coal lessee for the production and disposition of the coal produced. Gross proceeds includes, but is not limited to, payments to the lessee for certain services such as crushing, sizing, screening, storing, mixing, loading, treatment with substances including chemicals or oils, and other preparation of the coal to the extent that the lessee is obligated to perform them at no cost to the Federal Government or Indian lessor.

30 C.F.R. § 206.251 (1994).

The royalty value reported by a lessee is subject to monitoring, audit, and review. 30 C.F.R. § 206.257(b)(1). The regulations provide as follows:

In conducting reviews and audits, MMS will examine whether the contract reflects the total consideration actually transferred either directly or indirectly from the buyer to the seller for the coal produced. If the contract does not reflect the total consideration, then the MMS may require that the coal sold pursuant to the contract be valued in accordance with paragraph (c) of this section [concerning the value of coal not sold pursuant to an arm's-length contract]. Value may not be based on less than the gross proceeds accruing to the lessee for the coal production, including the additional consideration.

30 C.F.R. § 206.257(b)(2) (emphasis supplied).

The revised regulations also explicitly clarify that

[t]he lessee is required to place the coal in marketable condition at no cost to the Federal Government or Indian lessor. Where the value established pursuant to this section is determined by a lessee's gross proceeds, that value shall be increased to the extent that the gross proceeds has been reduced because the purchaser, or any other person, is providing certain services, the cost of which ordinarily is the responsibility of the lessee to place the coal in marketable condition.

30 C.F.R. § 206.257(h) (1994) (emphasis supplied).

Peabody argues that, given current market conditions, Minnesota Power's provision of the coal loadout facility has not "reduced" Peabody's gross proceeds. We find, however, that, under the 1968 coal supply agreement, the price for the coal reflects Peabody's production costs and escalates as those costs increase. Thus, if Peabody shouldered full responsibility for the expenses of loading the coal, those expenditures would be passed on to Minnesota Power in the form of a higher sales price. Since Minnesota Power provides the loadout facility and thereby assumes part of the costs of loading the coal, we conclude that MMS properly required Peabody to include the value of these assumed costs as part of its gross proceeds in determining the royalty value of the coal sold to Minnesota Power.

To the extent not specifically addressed herein, Peabody's arguments have been considered and rejected.

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

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David L. Hughes  
Administrative Judge

I concur:

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C. Randall Grant, Jr.  
Administrative Judge